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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	)	
	)	
1998 Biennial Regulatory Review --	)	CC Docket No. 98-81
Review of Accounting and Cost	)	
Allocation Requirements	)	
	)	
United States Telephone Association	)	ASD File No. 98-64
Petition for Rulemaking	)	
	)	

MCI REPLY COMMENTS

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SUMMARY

The Commission should reject the ILECs' proposals for sweeping changes to the Commission's accounting rules. The existing accounting rules remain relevant and important to the Commission's work, for two key reasons. First, the Commission continues to rely on accounting costs in ensuring that rates are just and reasonable, even under price cap regulation. Second, accounting safeguards will be increasingly critical as the scope of nonregulated and competitive services provided by the Bell Operating Companies (BOCs) and other ILECs expands.

Only eighteen months ago, the Commission found that accounting safeguards were essential to protecting ratepayers and ensuring BOC compliance with the provisions of Section 272 of the Act. The current debate about BOC provision of advanced data services through separate subsidiaries further highlights the need for well-formulated cost accounting and affiliate transactions rules. The Commission should not abandon its accounting rules at precisely the time when they are most critical to creating an environment of fair competition.

Neither Section 11 of the Act nor the adoption of price cap regulation justifies the sweeping changes to the Commission's accounting rules that the ILECs are proposing. Section 11(a)(2) obliges the Commission to repeal or modify only those rules no longer necessary as the result of "meaningful economic competition" between providers of telecommunications services. Because there is no "meaningful economic competition," the limited scope of the proposals in the Notice is fully consistent with Section 11 of the Act.

Accounting costs remain relevant even under price cap regulation. The Commission's price cap plan continues to provide for low-end adjustments and permits ILECs to file rate increases that exceed their applicable price cap indices. Further, both exogenous cost changes and the subscriber line charge (SLC) continue to be developed with reference to accounting costs. In addition to the direct role that accounting costs play in the Commission's price cap plan, the Commission continues to monitor the ILECs' interstate earnings as part of its overall evaluation of the reasonableness of the price cap regime.

There is no need for the Commission to review its Part 64 cost allocation and Part 32 affiliate transactions rules in this proceeding. Only eighteen months ago, in the Accounting Safeguards Order, the Commission reviewed and reaffirmed its cost allocation and affiliate transactions rules, finding that "adoption of the existing cost allocation rules and the affiliate transactions rules, as modified herein, will successfully achieve [the Commission's] goals." Indeed, many of the rules that the ILECs are asking the Commission to repeal are rules newly adopted in the Accounting Safeguards Order.

Nor should the Commission make the sweeping changes to the Part 32 account structure and accounting rules that the ILECs are proposing. The Commission must continue to ensure that the ILECs accounting practices are uniform and consistent, and must continue to require ILECs to report accounting information in sufficient detail for the Commission to monitor regulated/nonregulated allocations, conduct tariff investigations, and monitor the development of competition.

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MCI REPLY COMMENTS

I. Introduction

MCI Telecommunications Corporation (MCI) hereby submits its reply to comments on the Notice of Proposed Rulemaking in the above-captioned docket.[1]

The Commission should reject the ILECs' proposals for sweeping changes to the Commission's accounting rules. Even under price cap regulation, the Commission and state regulators continue to rely on accounting costs in ensuring that rates are just and reasonable. As long as this is the case, ratepayers must be protected by well-formulated cost accounting and affiliate transactions rules.

Indeed, the Commission's affiliate transactions rules are becoming more, not less, important as the scope of nonregulated and competitive services provided by the

[1] 1998 Biennial Regulatory Review -- Review of Accounting and Cost Allocation Requirements, CC Docket No. 98-81, FCC 98-108, released June 17, 1998 (Notice).

Bell Operating Companies (BOCs) and other ILECs expands. The Commission should not abandon its accounting safeguards at precisely the time when they are most critical to creating an environment of fair competition.

Many of the ILECs' proposals for changes to the Commission's cost accounting rules and affiliate transactions rules are based on a report prepared by Arthur Andersen LLP, "Accounting Simplification in the Telecommunications Industry."[2] At the request of MCI, the economic consulting firm Snavely King Majoros O'Connor & Lee, Inc. (Snavely King) has prepared an analysis of the Arthur Andersen report (see Attachment A).[3] As Snavely King demonstrates, Andersen's proposed changes to the Commission's Part 32 rules fail to recognize the purpose of these rules and the environment in which they operate. After analyzing Commission and state regulatory mechanisms, including the Commission's accounting rules, Snavely King concludes that "[d]espite the introduction of price cap plans, stringent accounting safeguards remain necessary."[4]

[2] Arthur Andersen LLP, "Accounting Simplification in the Telecommunications Industry," July 15, 1998.

[3] Snavely King Majoros O'Connor & Lee, Inc., "Report on Andersen Position Paper," September 4, 1998 (Snavely King Report).

[4] Snavely King Report at 37.

II. The Commission Should Make Only Those Limited Changes That Are Consistent With the Creation of a Fully Competitive Local Exchange and Exchange Access Market, Not the Sweeping Changes Proposed by the ILECs

The ILECs justify their broad proposals on two grounds: first, they point to Section 11(a)(1) of the Act, which requires the Commission to examine "all regulations issued under this Act,"[5] and second, they argue that the Commission's adoption of price cap regulation has rendered the Commission's accounting rules obsolete or irrelevant.[6] As discussed in detail below, however, neither Section 11 of the Act nor the adoption of price cap regulation justifies the sweeping changes to the Commission's accounting rules that the ILECs are proposing. In this proceeding, the Commission should make only those limited revisions that are consistent with the creation of a fully competitive local exchange and exchange access market, while continuing to protect ratepayers.

A. The Limited Scope of the Notice Proposals is Fully Consistent With Section 11 of the Act

While Section 11(a)(1) of the Act requires the Commission to review "all regulations issued under this Act," the ILECs are ignoring Section 11(a)(2), which obliges the Commission to repeal or modify only those rules no longer necessary as the result of "meaningful economic competition" between providers of telecommunications

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[5] See, e.g., SBC Comments at 1-2.

[6] Id. at 5.

services. If the Commission's accounting rules are evaluated according to this standard, it is clear that the Commission was correct to propose only limited changes at this time.

As the Commission is well aware, there has been little or no change in the level of competition for ILEC local exchange and exchange access services since the passage of the Telecommunications Act of 1996.[7] Almost without exception, the price cap ILECs -- the ILECs that allegedly face the most competition -- continue to price their interstate access services at the maximum permitted by the Commission's price cap rules. The ILECs have certainly presented no evidence in this proceeding that would allow the Commission to conclude that meaningful economic competition exists.

Because regulation, not "meaningful economic competition," is the sole constraint on ILEC prices, the Commission is not obliged to repeal or modify any of the regulations that it has adopted to ensure that rates are just and reasonable, including the USOA account structure and accounting rules, the Part 64 cost allocation rules, and the

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[7]MCI recently submitted to the Commission a report demonstrating the absence of competition in the exchange access market. Letter from Mary L. Brown, MCI, to Richard Metzger, FCC, May 7, 1998, CC Docket No. 96-262, Access Charge Reform; RM 9210. See also In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to provide In-Region, InterLATA Services in Michigan, Memorandum Opinion and Order, CC Docket No. 97-137, released August 19, 1997 (Michigan 271 Order); In the Matter of Application by SBC Communications Inc. Pursuant to Section 271 of the Communications Act of 1934, as amended, to provide In-Region InterLATA Services in Oklahoma, Memorandum Opinion and Order, CC Docket No. 97-121, released June 26, 1997 (Oklahoma 271 Order); In the Matter of Application by BellSouth Corporation Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region InterLATA Services in South Carolina, Memorandum Opinion and Order, CC Docket No. 97-208, released December 24, 1997 (South Carolina 271 Order).

Part 32 affiliate transactions rules. The limited scope of the proposals in the Notice is thus fully consistent with Section 11(a) of the Act.

B. The "Burden" of Compliance with the Commission's Accounting rules is Irrelevant to a Section 11 Analysis and is Exaggerated by the ILECs

A constant theme of the ILECs' comments is that compliance with the Commission's accounting rules imposes a substantial cost burden on the ILECs.[8] In an effort to quantify the cost of compliance, Arthur Andersen compared the cost of several large ILECs' accounting function with that of similarly-sized companies outside the telecommunications industry. On average, Arthur Andersen found that the ILECs' costs were approximately $10.5 million higher.[9]

The cost of compliance with the Commission's accounting rules is irrelevant to the Commission's analysis under Section 11 of the Act. Section 11 requires the Commission to take action only when it has determined that a regulation is no longer necessary because of "meaningful economic competition." As long as there is no "meaningful economic competition," nothing in Section 11 requires the Commission to conduct a cost-benefit analysis or otherwise revisit the reasoning underlying the existing rule.

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[8]See, e.g., BellSouth Comments at 5.

[9]Snavely King Report at 6.

In any event, the ILEC claim that there is a severe cost burden resulting from the USOA is refuted by the Andersen study itself. Even if Arthur Andersen's cost estimates are accepted at face value, the average large ILEC studied by Arthur Andersen spends only $10.5 million more on its accounting function than a similarly-sized non-ILEC. Given that the ILECs studied by Arthur Andersen had, on average, operating telephone company revenues of $13.8 billion in 1997, an added expenditure of $10.5 million in the public interest, or less than 0.08 percent of revenues, can be considered a trivial cost burden.[10]

C. The Commission Should Reject the Argument that its Adoption of Price Cap Regulation Justifies Wholesale Revisions to the Accounting Rules

The Commission should also reject the ILEC argument that price cap regulation has rendered accounting costs, and thus accounting rules, irrelevant. While the day-to-day operation of price cap mechanisms does not rely on accounting costs, accounting costs continue to play a key role in the Commission's regulation of ILEC rates.

First, the Commission's price cap plan continues to permit a low-end adjustment when an ILEC's interstate rate of return falls below 10.25 percent.[11] Second, the price

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[10]Snavely King Report at 6-7.

[11]In the Matter of Price Cap Performance Review for Local Exchange Carriers, Fourth Report and Order, CC Docket No. 94-1, released May 21, 1997, at ¶127 (1997 Price Cap Performance Review Order), appeal pending sub nom., United States Telephone Association v. Federal Communications Commission, No. 97-1469 (D.C. Cir.).

cap rules permit ILECs to file rate increases that exceed their applicable price cap indices, provided that they satisfy a stringent cost showing.[12] Third, under the Commission's price cap plan, exogenous cost changes continue to be computed with reference to accounting costs. Fourth, price cap ILECs continue to develop their subscriber line charge (SLC) with reference to accounting costs.[13]

In addition, reported accounting costs are often used to assess the reasonableness of ILEC new services cost support. For example, the Commission used cost information reported in ARMIS to evaluate the ILECs' expanded interconnection tariffs, noting that "the ARMIS overhead levels represent the best currently available verifiable surrogate for overhead loadings for other services."[14] As Snavely King points out, "no price cap plan can protect ratepayers if the initial rates, upon which the plan is based, are excessive."[15]

The ILECs seek to downplay the role that accounting costs play in the Commission's price cap plan. For example, Arthur Andersen states that the low-end

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[12]See Accounting Safeguards Order at ¶271 (citing Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6823, ¶¶303-304 (1990)).

[13]47 C.F.R. §69.152(b)(1).

[14]In the Matter of Ameritech Operating Companies Revisions to Tariff F.C.C. No. 2, Transmittal Nos. 697, 711, Order, 8 FCC Rcd 4589, ¶¶32-37 (1993).

[15]Snavely King Report at 8 (emphasis in original).

adjustment has been rarely used.[16] The limited use of the low-end adjustment mechanism is hardly surprising, given that the X-Factor in effect during the first several years of price cap regulation was extremely generous to the ILECs. Further, while they downplay the role of the low end adjustment mechanism in this proceeding, the ILECs have shown no reluctance to claim low end adjustments. GTE has claimed a low-end adjustment for some study areas in recent annual access filings,[17] and SWBT initially claimed a low-end adjustment in this year's annual access filing.[18] Similarly, SNET and Citizens have both filed petitions for waiver of the 6.5 percent X-Factor, arguing that their earnings are likely to fall below 10.25 percent.[19]

In addition to the direct role that accounting costs play in the Commission's price cap plan, the Commission continues to monitor the ILECs' interstate earnings as part of

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[16]Arthur Andersen LLP, "Accounting Simplification in the Telecommunications Industry," July 15, 1998, p. 11 n.14.

[17]Despite aggregate interstate earnings of over 20 percent in 1997, GTE claimed a low-end adjustment in its 1998 annual access filing in four study areas: GTAR, GNCA, GTMN, and COKY. Letter from Meade C. Seaman, GTE, to Magalie Roman Salas, Secretary, FCC, April 2, 1998, Section XI.

[18]In its April 2, 1998 TRP filing, SWBT claimed a low-end adjustment of $58 million. Letter from David T. Ho, SWBT to Magalie Roman Salas, Secretary, FCC, April 2, 1998, p. 2-10. SWBT subsequently rescinded this claim after finding that the rate of return first reported had been corrupted by problems resulting from the conversion to a new computer system. 1998 Price Cap Revisions, SBC Reply Comments at 1-2, April 30, 1998.

[19]SNET Files Petition for Waiver and/or Amendment of Part 61 of the Commission's Rules Establishing an "X-Factor" of 6.5%, 12 FCC Rcd 12124 (1997); Citizens Utilities Company Files Emergency Petition for Waiver of New X-Factor Rules, 12 FCC Rcd 11561 (1997).

its overall evaluation of the reasonableness of the price cap regime. It was after such an evaluation of ILEC performance under price caps that the Commission concluded that there was a need for substantial revisions to its price cap rules.[20] The next performance review is scheduled for 1999; as part of this review, the Commission will evaluate industry-wide performance to determine whether the price cap plan is leading to unreasonably high or low rates.[21]

The Commission's accounting rules also play a key role in ensuring that intrastate rates are just and reasonable. The Part 32 and Part 64 rules determine the "subject to separations" costs that are then allocated between the interstate and intrastate jurisdictions. As the Commission has recognized, "because . . . incumbent local exchange carriers' intrastate services may be subject to cost-of-service regulation or to a form of price cap regulation that involves potential sharing obligations or periodic earnings reviews, the incumbent local exchange carriers may still have an incentive to assign a disproportionate share of costs to regulated accounts."[22]

Snavely King points out that eighteen state commissions and the District of Columbia continue to set intrastate rates based on traditional rate of return regulations.[23]

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[20]In the Matter of Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8961 (1995) (1995 Price Cap Performance Review Order).

[21]1997 Price Cap Performance Review Order at ¶¶166-167.

[22]Accounting Safeguards Order at ¶271.

[23]Snavely King Report at 7.

Many of the remaining 32 states have limited the term of their price cap or incentive regulation plans, calling for earnings reviews at the end of those terms. Almost all price cap states monitor earnings so as to be able to adjust their formulas as required.

Finally, accounting costs serve a variety of new functions as a result of the Telecommunications Act of 1996. The Commission and state regulators have employed the USOA's detailed cost data in order to calculate wholesale discounts and UNE and interconnection prices.[24] While the methodologies used for much of the costing of UNEs and interconnection under the 1996 Act is forward-looking and does not rely explicitly on historical accounting data, the models used in this costing often employ factors such as expense to investment ratios that are derived from cost information reported in ARMIS.[25]

D. The Commission Should Make Only Those Changes That Will Facilitate the Creation of a Fully Competitive Local Exchange and Exchange Access Market, While Continuing to Protect Ratepayers

Far from being irrelevant, accounting costs continue to have significant implications for the rates paid by the ILECs' customers. For example, even seemingly minor changes in a carrier's reported rate of return can have a significant impact on

[24]In the Matter of Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, rel. August 8, 1998, at ¶¶898-906, 917-918.

[25]See GTE Telephone Operating Companies: Release of Information Obtained During Joint Audit, Memorandum Opinion and Order, AAD 98-26, released March 18, 1998, at ¶6.

ratepayers. A misassignment of costs sufficient to reduce a large ILEC's reported rate of return 0.5 percentage points, from 10.25 percent to 9.75 percent, would trigger a low-end adjustment of approximately $25-$30 million -- substantially more than the incremental compliance costs estimated by Arthur Andersen.

Furthermore, the importance of the Commission's accounting rules is growing as the scope of ILEC involvement in nonregulated and competitive activities expands. The BOCs, in particular, are permitted to engage in a broad range of previously proscribed activities provided they comply with the safeguards prescribed in Section 272.[26] The Commission has also proposed allowing ILECs to offer advanced services through a separate affiliate.[27] With ILEC entry into these markets, there will be a significant increase in the number of affiliate transactions and, furthermore, increased investment and expenses that could, if misallocated, have a significant impact on ratepayers.

As long as the ILECs' accounting practices have implications for the rates paid by the ILECs' customers, the Commission cannot make the sweeping changes that the ILECs propose. The Commission must continue to ensure, first, that an appropriate portion of the ILECs' costs are allocated to nonregulated activities.[28] Second, the Commission must continue to ensure that the ILECs' accounting practices are uniform

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[26]See, e.g., Accounting Safeguards Order at ¶¶3-4, 26.

[27]Deployment of Wireline Services Offering Advanced Telecommunications Capability, Memorandum Opinion and Order and Notice of Proposed Rulemaking, CC Docket No. 98-147, rel. August 7, 1998 at ¶¶95-99.

[28]See Joint Cost Order, Accounting Safeguards Order.

and consistent.[29] Third, the ILECs must continue to report accounting information in sufficient detail for the Commission to monitor regulated/nonregulated allocations, conduct tariff investigations, and monitor the development of competition. As discussed below, the ILECs' proposals would weaken the cost allocation and affiliate transactions rules, allow the ILECs' substantial discretion in their accounting practices, and reduce the level of accounting detail available to the Commission.

At most, the Commission should make limited and targeted revisions to its accounting rules. Modification or repeal may be appropriate, for example, if particular accounts are no longer needed because of changes in ILEC technology or the deregulation of specific services. MCI does not oppose some of the proposals in the Notice, such as the consolidation of Accounts 2114-2116 into a single account. There may also be other opportunities for account consolidation, such as the elimination of the subaccounts in Account 2215, Electro-mechanical switching. However, for the reasons discussed above, the ILECs' core argument -- that the Commission can undertake a sweeping revision of its accounting rules because accounting costs are no longer relevant -- has no basis.

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[29] See Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles, Report and Order, 102 FCC 2d 964, 984-985 (1985) (GAAP Order).

III. The Commission Should Reject the Proposed Changes to the Part 32 Accounting Rules

The ILECs propose wide-ranging changes to the Commission's Part 32 accounting rules. The ILECs propose that the Commission (1) eliminate many of the detailed instructions in Section 32.2000 of the Commission's rules and rely to a greater extent on GAAP; (2) significantly reduce the level of accounting detail by allowing the ILECs to use Class B accounting; (3) permit the ILECs to determine depreciation rates pursuant to GAAP; and (4) reduce basic property record (BPR) and continuing property record (CPR) record-keeping requirements.

A. The Commission Cannot Rely Exclusively on GAAP

In their comments, the ILECs urge the Commission to permit ILECs to rely on GAAP to a much greater extent.[30] But, as Snavely King discusses, the Commission has consistently found that full reliance on GAAP may be inappropriate for regulatory purposes.[31] GAAP is guided by a "conservatism" principle that, as the Commission has recognized, is effective in protecting the interests of investors but may not always protect the interest of ratepayers.[32]

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[30]See, e.g., USTA Comments at 27-28.

[31]Snavely King Report at 9-10.

[32]Prescription Simplification, Report and Order, rel. Oct. 20, 1993, ¶46.

The Commission should reject ILEC proposals that they be permitted to adopt the GAAP definition of materiality. As the Commission discussed in the GAAP Order, "the GAAP definition of materiality leaves too much to the discretion of parties not bound by our public interest responsibilities to be viable in a regulatory accounting scheme."[33] Snavely King points out that the expense limits consistent with GAAP could increase the expenses reported by an ILEC in a given period, resulting in low-end adjustments and masking inadequate productivity offsets.[34]

The ILECs also urge the Commission to eliminate the requirement that they notify the Commission prior to adopting new accounting standards. However, the prior review period allows the Commission to assess the implications of GAAP changes for ILEC revenue requirements. Equally importantly, the review period permits the Commission to ensure uniformity in accounting practices: pursuant to the GAAP Order, the Commission will select the accounting method carriers are to use under GAAP when GAAP permits several accounting options. For example, after evaluating the two options that SFAS-106 permitted for recognizing the transition from a cash basis to accrual basis for accounting for Other Post-Employment Benefits (OPEBs), the Commission required all ILECs to amortize the transition obligation over 20 years.[35]

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[33]GAAP Order, 102 FCC 2d at 986.

[34]Snavely King Report at 29-30.

[35]Southwestern Bell and GTE Service Corporation Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting For Postretirement Benefits Other Than Pensions, Order, 6 FCC Rcd 7560 (1991).

The Commission found that the other option, a flash-cut approach, would have seriously distorted the carriers' operating results.[36]

B. All ILECs Should Continue to Use Class A Accounts

In the Notice, the Commission proposed allowing mid-sized ILECs to use Class B accounting, while the BOCs and GTE would continue to use Class A accounting.[37] The Commission tentatively concluded that Class A accounting for the BOCs and GTE was necessary for the Commission to uphold its statutory obligations under Sections 254(k), 260, 271, 272, 273, 274, 275, and 276 of the Act. In their comments, the BOCs and GTE dispute the Commission's assessment that "the level of detail of the Class A accounting rules allows [the Commission] to identify potential cost misallocations beyond those revealed by the Class B system of accounts."[38]

Contrary to the ILECs' contentions, Class A accounting detail is a valuable tool for detecting cost misallocations and cross-subsidy. The ARMIS 43-03 Joint Cost Report shows, by account, the amount that each ILEC has allocated using direct assignment, the amount allocated using direct or indirect measures of cost causation, and the amount allocated using general allocators. If ARMIS 43-03 reports are filed at the Class A level of detail, the Commission and interested parties are better able to track the

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[36]Id.

[37]Notice at ¶¶4,6.

[38]Id. at ¶6.

nonregulated/regulated allocations for different technologies and functions. At the Class A account level, for example, the Commission can distinguish between analog and digital switching investment, which have very different regulated/nonregulated allocation percentages.[39]

Class A accounting also requires the ILECs to maintain subsidiary records for metallic and non-metallic (fiber) facilities. The Commission has noted that the ILECs have deployed a significant amount of fiber that is intended for competitive services, and recently tentatively concluded that "ratepayers of voice-grade services, over which ILECs still exert market power, should not be paying for the spare facilities that eventually will be used for more competitive services."[40] While the metallic/nonmetallic breakdown is not currently reported in ARMIS, the statutory requirement that the Commission prevent cross-subsidization of competitive activities justifies maintaining the metallic/nonmetallic subsidiary records. Indeed, given the importance of fiber investment data, the Commission should consider requiring separate accounts for metallic and nonmetallic facilities and requiring the ILECs to report these costs in ARMIS.

Furthermore, Class A accounting is routinely used to determine the reasonableness of overhead loading factors and expense ratios used in new services cost

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[39]See Snavely King Report at 15-16.

[40]Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, Notice of Proposed Rulemaking, CC Docket No. 80-286, released October 7, 1997, at ¶71.

support.[41] Class A accounting data has also been used extensively in developing wholesale rates and cost study inputs for determining UNE and interconnection prices pursuant to the Telecommunications Act of 1996.[42]

C. Depreciation Issues

The Commission has indicated that depreciation issues will be addressed in a separate proceeding.[43] Nonetheless, several ILECs raise depreciation-related issues in this proceeding. They suggest, in particular, that the Commission allow ILECs to determine the applicable depreciation rate for each account based on GAAP standards.[44]

The flexibility in determining depreciation rates that the ILECs seek would be at odds with the Commission's objectives of ensuring consistency and uniformity in ILEC accounting practices. Furthermore, given the ILECs' incentive to keep reported regulated earnings low, and the conservative bias of GAAP, it is likely that the ILECs

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[41] In the Matter of Ameritech Operating Companies Revisions to Tariff F.C.C. No. 2, Transmittal Nos. 697, 711, Order, 8 FCC Rcd 4589, ¶¶32-37 (1993).

[42] In the Matter of Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, rel. August 8, 1998, at ¶¶898-906, 917-918.

[43] FCC Staff Proposes 31 Proceedings as Part of 1998 Biennial Regulatory Review, Report No. GN 98-1, February 5, 1998.

[44] See, e.g., USTA Comments at 26.

would find it appropriate to raise their depreciation rates to levels which would best protect investor interests.[45]

Snavely King also points out that the end to Commission review of plant lives and salvage values that the ILECs are proposing would leave the State Commissions and the public without an unbiased perspective on these parameters for use in cost studies.[46] In interconnection arbitration cases across the country, State commissions have found Commission prescribed (or similar State prescribed) depreciation parameters appropriate for use in Total Element Long-Run Incremental Cost (TELRIC) studies.[47]

D. The Commission Should Not Relax Record-Keeping Requirements

The ILECs propose the elimination of several requirements in Section 32.2000 of the Commission's rules, particularly the detailed Basic Property Record (BPR) and Continuing Property Record (CPR) requirements in Sections 32.2000(e) and (f). They argue that more general instructions would be sufficient.[48]

The Commission has made clear that price cap regulation does not eliminate the requirement for accurate plant records. The Commission recently stated that "accurate plant accounts play a vital role in monitoring financial results, calculating low-end

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[45]Snavely King Report at 26.

[46]Id..

[47]Id.

[48]See, e.g., USTA Comments at 25-26.

earnings adjustments, determining productivity factors for price cap companies, defining and resolving stranded investment issues, determining the basis for jurisdictional separations, and deriving inputs for forward-looking cost models for universal service, interconnection agreements, and access prices."[49]

The recent findings of the joint audit team that examined GTE's BPR cast doubt on any step that would give the ILECs' increased flexibility in tracking their assets. Not only did the joint audit team find that GTE's basic property records were not in compliance with Part 32, but GTE itself admitted that, after a comprehensive inventory of its central office equipment, a substantial portion of the assets shown in its basic property records could not be located.[50] For example, according to GTE, the inventory resulted in a $289.5 million reduction in the GTE California Inc. BPR.[51]

Reported costs that cannot be supported by the ILEC's plant records have significant consequences for the regulatory process. In particular, the overstatement of plant assets results in an overstatement of depreciation expense, decreasing the reported rate of return and, in the case of a price cap ILEC, possibly triggering an erroneous low-

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[49]GTE Telephone Operating Companies: Release of Information Obtained During Joint Audit, Memorandum Opinion and Order, AAD 98-26, released March 18, 1998, at ¶6.

[50]Arkansas Public Service Commission et. al., Joint Audit Report on the Basic Property Records of GTE Corporation's Telephone Operating Companies, December 1997 (GTE Audit Report).

[51]GTE Audit Report at 10.

end adjustment. Similarly, plant expense ratios critical to service cost studies are overstated when current expenses are related to overstated plant balances.[52]

The elimination of the requirement to track the existing assets and the service life of property retired would deprive regulators of data which remains especially useful to the depreciation process.[53] Data on the actually experienced service lives of plant remains important to provide a perspective on the reasonableness of proposed lives.[54]

IV. No Changes to the Cost Allocation and Affiliate Transactions Rules are Warranted

As discussed above, well-formulated cost allocation and affiliate transactions rules are becoming even more essential as the scope of ILEC involvement in nonregulated and competitive activities expands. Affiliate transactions rules, in particular, are of growing importance as the BOCs enter previously prescribed markets through Section 272 affiliates and, if the Commission adopts the proposals in the Advanced Services Notice, other ILECs begin to provide advanced services through separate affiliates.

The ILECs, however, are proposing that the Commission weaken substantially its Part 64 cost allocation rules and Part 32 affiliate transactions rules. Proposed changes to

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[52]Snavely King Report at 28.

[53]Id. at 29.

[54]Id.

the Part 64 cost allocation rules include (1) eliminating the requirement that ILECs notify the Commission of CAM changes; (2) eliminating the requirement that ILECs quantify the effects of CAM changes; and (3) reducing the frequency of CAM audits. Proposed changes to the Part 32 affiliate transactions rules include (1) eliminating the requirement that competitive regulated services be treated as nonregulated for accounting purposes; (2) eliminating the 50 percent threshold for use of the prevailing price valuation method; (3) extending the "FDC exemption" to a broader range of services; and (4) eliminating the requirement that fair market value studies be conducted for services transactions.

There is no need for the Commission to review its Part 64 cost allocation and Part 32 affiliate transactions rules in this proceeding. Only eighteen months ago, in the Accounting Safeguards Order, the Commission reviewed and reaffirmed its cost allocation and affiliate transactions rules, finding that "adoption of the existing cost allocation rules and the affiliate transactions rules, as modified herein, will successfully achieve [the Commission's] goals."[55] Indeed, many of the rules that the ILECs are asking the Commission to repeal are rules newly adopted in the Accounting Safeguards Order.[56]

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[55]Accounting Safeguards Order at ¶26.

[56]Among the rules adopted in the Accounting Safeguards Order that the ILECs are asking the Commission to repeal in this proceeding are: (1) the 50 percent threshold for use of the prevailing price standard (Accounting Safeguards Order at ¶¶135-136); (2) the requirement that the ILECs conduct fair market value studies for services transactions (Accounting Safeguards Order at ¶147); and (3) the requirement that competitive